Module 1: Foreign Exchange Markets – An Overview

1. Explain the features and functions of the foreign exchange market.

Answer: The foreign exchange (forex) market is a decentralized market where currencies are traded globally.

• Features:

• Operates 24/7 across different time zones.

• High liquidity with continuous trading.

• Involves multiple participants (banks, traders, governments).

• Prices fluctuate based on supply and demand.

• Functions:

• Facilitates international trade and investment.

• Determines currency exchange rates.

• Allows hedging against foreign exchange risks.

• Provides opportunities for speculation and arbitrage.

2. Discuss the various participants in the forex market and their roles.

Answer: Participants include:

• Central Banks – Regulate and stabilize the currency.

• Commercial Banks – Facilitate currency exchange for businesses and individuals.

• Hedge Funds & Investors – Trade for profit and speculation.

• Corporations – Engage in forex for international trade.

• Brokers & Dealers – Act as intermediaries for forex transactions.

3. Differentiate between VOSTRO, NOSTRO, and LORO accounts with examples.

Answer: • NOSTRO Account: A domestic bank’s account in a foreign bank (e.g., SBI having an account in Citibank USA).

• VOSTRO Account: A foreign bank’s account in a domestic bank (e.g., Citibank USA having an account in SBI).

• LORO Account: A bank referring to another bank’s NOSTRO account (e.g., Bank of India referring to SBI’s account in Citibank USA).

4. Explain different types of foreign exchange risks and the role of FEDAI.

Answer: •Types of Forex Risks:

• Transaction Risk – Loss due to exchange rate fluctuations in transactions.

• Translation Risk – Impact on financial statements of multinational companies.

• Economic Risk – Long-term risk affecting business competitiveness.

• Role of FEDAI (Foreign Exchange Dealers Association of India):

• Sets forex trading rules for banks.

• Regulates exchange rates and commission charges.

• Provides training and guidelines on forex transactions.

5. What are FERA and FEMA regulations? Compare their impact on foreign exchange in India.

Answer: • FERA (Foreign Exchange Regulation Act, 1973): Strict regulations on foreign exchange transactions; required RBI approval for foreign investments.

• FEMA (Foreign Exchange Management Act, 1999): Liberalized foreign exchange policies, promoting easier investment and trade.

• Comparison: FEMA replaced FERA to encourage globalization, ease forex controls, and support foreign investments.

6. Define capital account convertibility. What are its advantages and limitations?

Answer: • Definition: Capital account convertibility allows unrestricted conversion of domestic currency into foreign currency for capital transactions (investment, borrowing).

• Advantages:

• Increases foreign investment.

• Improves economic growth.

• Strengthens global financial integration.

• Limitations:

• Risk of capital flight.

• Increases financial instability.

• Requires strong monetary policies.

7. Discuss the distinction between fixed and flexible exchange rates, highlighting their advantages and disadvantages.

Answer: • Fixed Exchange Rate: Currency value is pegged to another currency (e.g., Gold Standard).

• Flexible Exchange Rate: Currency value fluctuates based on market demand (e.g., Indian Rupee).

• Advantages of Fixed Rate: Stability, reduces inflation.

• Disadvantages of Fixed Rate: Requires large foreign reserves, inflexible monetary policies.

• Advantages of Flexible Rate: Adjusts to economic conditions, no need for large reserves.

• Disadvantages of Flexible Rate: Can lead to high volatility.

8. Explain the role of RBI in managing the foreign exchange market in India.

Answer: • Manages exchange rates and forex reserves.

• Intervenes to stabilize currency fluctuations.

• Regulates foreign exchange transactions under FEMA.

• Implements policies for trade and investment facilitation.

Module 2: Derivatives Market

1. Define derivatives and explain their features, benefits, and disadvantages.

Answer: • Definition: A derivative is a financial contract whose value is based on an underlying asset (e.g., stocks, commodities, currency).

• Features: Traded in organized markets, involves speculation, risk management.

• Benefits: Hedging against risks, profit from price fluctuations.

• Disadvantages: High risk of losses, requires expertise, speculative in nature.

2. Discuss the types of foreign exchange quotations with examples.

Answer: • Direct Quote: Domestic currency per unit of foreign currency (e.g., ₹82 = $1).

• Indirect Quote: Foreign currency per unit of domestic currency (e.g., $1 = ₹82).

3. Explain direct and indirect exchange rates with numerical illustrations.

Answer: • Direct Rate Example: ₹75 = $1 (USD/INR).

• Indirect Rate Example: 0.0133 USD = ₹1 (INR/USD).

4. What is the significance of forward rates? How are they calculated?

Answer: • Significance: Helps businesses hedge against currency fluctuations.

• Formula: Forward Rate =

$$SpotRate \times \left(\frac{1 + DomesticInterestRate}{1 + ForeignInterestRate}\right)$$

5. Define spread and cross rates. How do they impact forex transactions?

Answer: • Spread: Difference between bid and ask price of a currency.

• Cross Rate: Exchange rate between two currencies derived from a common third currency (e.g., INR/USD via EUR/USD).

• Impact: Determines forex trading costs, profitability, and arbitrage opportunities.

6. Explain the emerging structure of the derivatives market in India.

Answer: • Regulated by SEBI and RBI.

• Increasing participation of investors.

• Introduction of new financial instruments like currency futures and options.

7. Discuss the different types of derivatives in India, focusing on futures, options, and swaps.

Answer: • Futures: Agreement to buy/sell an asset at a future date.

• Options: Right (not obligation) to buy/sell an asset at a fixed price.

• Swaps: Exchange of cash flows (e.g., interest rate swaps).

8. Solve a numerical problem on spot and forward rates in foreign exchange derivatives.

Problem: If the spot rate of USD/INR is ₹82, the domestic interest rate is 5%, and the US interest rate is 3%, calculate the one-year forward rate.

Solution:

Using the formula:

$$ForwardRate = 82 \times \left(\frac{1+0.05}{1+0.03}\right)$$

$$= 82 \times \left(\frac{1.05}{1.03}\right) = 82 \times 1.0194 = 83.59$$

Thus, the one-year forward rate is **₹83.59/USD**.

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